

Management Discussion and Analysis

PERFORMANCE REVIEW

In 2006, the Group successfully achieved a turnaround. During the Reporting Period, the Group recorded a turnover of RMB6.564 billion from its principal operations, and net profit of approximately RMB48.5 million (2005: losses of approximately RMB3.791 billion) and earnings per share of approximately RMB0.07. These results are attributable to the following reasons:

- (1) The costs and expenses incurred by the Company were significantly lower than previous years as a result of the gradual implementation and adoption of various costs control measures during the year. The structure of product sales of the Company improved substantially while the volume of sales was maintained, the gross profit margin rose substantially and profitability of products of the Company was strengthened.
- (2) The Company received subsidies for technological upgrade and innovation in the sum of RMB70 million from the Ronggui Street Office, Shunde District, Foshan City on 25 December 2006.
- (3) Revenues from the disposal of idle assets by the Company

Despite still facing great difficulties in its operations during the Reporting Period, the Company continued to pursue its operational guidelines of “optimizing internal systems, improving cash flow, continuing high-end strategy and maintaining operational efficiency”, and implemented the Sales Agency Agreement and its supplementary agreements entered into between the Company and Qingdao Hisense Marketing Company Limited. With the full understanding and support from governments at various levels, banks, suppliers and distributors and the concerted efforts of all our staff, the production and sales activities of the Company were gradually improving, with the profit margin of products and the liquidity of assets further enhanced, and the quality of operations improved notably as compared to 2005. As at the end of the Reporting Period, the Company has resumed normal business operations in all aspects and has accomplished its primary objectives of rescuing Kelon, maintaining stability and protecting its brandname.

Operation Structure Analysis

During the Reporting Period, the sales revenues of refrigerators, air-conditioners and freezers accounted for 50.70%, 38.59% and 3.53% of the total revenues of the principal operations of the Company, respectively, while the remaining 7.18% of the total revenues generated from other businesses. Among which, domestic and export sales accounted for 65.51% and 34.49% of the total revenues of the principal operations of the Company, respectively.

Refrigerators business

During the Reporting Period, competition was still keen in the refrigerators’ market. Despite being affected by various adverse factors, the Company insisted to adhere to technological innovation, aggressively optimized the product mix of its refrigerators and underwent a major restructuring in both domestic and export sales channels, thereby consumers’ confidence recovered significantly and our market share improved rapidly. Meanwhile, the Company significantly improved the quality of its operation while maintaining a growth in sales. As such, the gross profit margin of its products has substantially increased. During the Reporting Period, the refrigerators business of the Company recorded a sales revenue of approximately RMB3.328 billion, representing an increase of 30.87% as compared to the same period of the previous year, and has therefore secured its leading position in the industry in the PRC. During the Reporting Period, the refrigerators business of the Company recorded a profit from principal operations of approximately RMB150,644,000.

Air-conditioners business

During the Reporting Period, as a result of the breach of laws and regulations of the former substantial shareholder of the Company in 2005, the exporting orders of air-conditioners of the Company decreased significantly, resulting in a decrease in the sales volume as compared to the corresponding period of the previous year. However, the Company, on one hand, adhered to its high-end strategy, intensified its research and technology development, continued to launch new products with high efficiency and energy-saving features under its market orientation policy, rebuild the market influence of its brandname and enhanced product competitiveness. On the other hand, by taking measures such as optimization of product design, establishment of strategic reserve, improvement of cash flow, reduction of locked-in funds and improvement of quality assurance system, the Company, to some extent, offset the adverse effects of factors including the increasing price of raw materials and significantly reduced various costs and expense. As such, the operation quality of the air-conditioners segment of the Company improved significantly during the Reporting Period.

The Company recorded a sales revenue of RMB2.533 billion for its air-conditioners business during the Reporting Period, representing a decrease of 29.64% as compared to 2005. However, the profitability of its air-conditioners business was significantly improved with the profit margin for the principal operations of the air-conditioners business enhanced significantly, a profit of RMB22 million was recorded for the principal operations.

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Technology, Research and Development

During the Reporting Period, on the regimes of technology, research and development, the Company obtained impressive results:

The Company was granted an aggregate of 48 refrigerators' patents and 71 air-conditioners' patents.

On the research and development of refrigerator products, the Company is in a leading position among its domestic counterparts in the fields of core energy-saving and freshness-retention technologies and measurement management. During the Reporting Period, Ronshen refrigerator won the "Energy Saving Grand Prix" again, which was granted by the United Nations Development Programme, the Global Environmental Fund and the State Administration of Environmental Protection. The Company's BCD-215YMB refrigerator with the brand of "Ronshen" was awarded the "Best Selling Refrigerator" award at the "2006 Seminar on the Development Trend of Refrigerator" jointly held by China Household Electric Appliance Research Institute (中國家用電器研究院) and China Electronic Chamber of Commerce (中國電子商會) etc. The measurement management system adopted by the Company was recognized by authoritative organizations and attained the highest 3A rating.

On the research and development of refrigerator products, during the Reporting Period, the Company's "VC" cabinet-type air-conditioner won the "IF China Design Award" for its novelty and fashionable appearance, which is the only award winning product in the PRC air-conditioning industry, reflecting that the leading position of the Company in designing air-conditioners in China has been continuously maintained.

OUTLOOK

On 13 December 2006, the equity transfer procedures of transferring the legal person shares in the Company held by Guangdong Greencool Enterprise Development Company Limited to Qingdao Hisense Air-conditioning Company Limited ("Hisense Air-Conditioner") was completed and became the single largest shareholder of the Company. With Hisense formally becoming the shareholder of the Company, the confidence and expectation on the future prospects of the Company from different sectors of the community improved significantly, the co-operation between the Company and banks, distributors and suppliers fully resumed. The major adverse factors restraining the development of the Company had basically been eliminated, which lays strong foundation for future expansion and improvement of competitiveness of the Company.

In 2007, the Company will adhere to the operating guidelines of "forging competitive edge of products, improving cash flow, enhancing management efficiency, strengthening talent training and capitalizing on the effectiveness of integration", so as to make new breakthrough in the development of the Company.

- (1) The Company will, as in the past, adhere to its principle of "leading in technology, products with quality", and increase investments in technological research and development, particularly in the global frontline technology of household electrical appliance and refrigeration industry. The Company will be able to maintain and create a leading advantage in technology through continuous technological research and the introduction of critical technology. Also, the Company will place an emphasis on upgrading its products and cultivating its market reputation as a technologically advanced company based on products quality. Further, the Company will maintain the leading position of its products in the current and future markets, so as to maintain the continuous development momentum and profitability of the Company.
- (2) The Company will explore the intrinsic value of the brandnames, Kelon and Ronshen, enhance the image of Kelon and Ronshen, increase brand building and promotion in 2007 to make up for the adverse impacts on the brandnames due to historical reasons in prior periods and improve the reputation and, recognition of the Company's brandname through reshaping the image of Ronshen and promoting the brandname of Kelon to support the healthy development of the Company.
- (3) In the domestic market, the Company will, on the one hand, continue to focus on direct sales channels represented by large chain stores, and co-operate closely with manufacturers and strengthen the retail network; and on the other hand, continue to rely on and further develop the traditional agency channel, strengthen the development of sales channels and open up development of third-tier and fourth-tier markets to accelerate the expansion of its market size.
- (4) On the overseas market, the Company will adhere to the parallel development of its self-owned brands and OEM brands. On one hand, the Company will continue and consolidate the advantage of co-operating with international leading brands and major clients, establish long-term strategic partnership with them and enlarge the export scale rapidly; and on the other hand, the Company will leverage on other advantageous resources in well established markets, devote to the development of local markets, develop more diversified customers, expand vigorously the export of self-owned brands, enhance international recognition of the Company's self-owned brand products and improve the profitability of export sales on the existing basis.

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- (5) The Company will adhere to the concept of “health accounts more than speed and profit accounts more than scale” in the implementation of a prudent financial policy, and make all decisions in a prudent manner. The Company will adhere to the strategy of steady development. In 2007, the Company will make an effort to tap its assets and various idle funds, optimize the coordination of supply, production and sales, adjust and reform its workflow, and improve the Company’s operating performance by accelerating cash flow and enhancing the operational profitability of the Company.
- (6) While reinforcing the training of its own human resources , the Company will coordinate and plan to attract external talents, especially the highly skilled technical personnel, so as to meet the needs of internationalization and continuous development of the Company.

Each of the above guidelines is addressed from the perspectives of exploring the Company’s own internal potentials, operating and managing the Company with a solid and sound management system, and focusing on the Company’s long-term sustainable development. As such, a brand new operating model of Kelon will be established to develop and cultivate its core competitiveness, which will surely play a very important role in enhancing the Company’s operating performance and strengthening its competitive edges which is solid and healthy with notable technological advantage, excellent operating performance, and long-term growth potential.

Looking forward, the Company sees both opportunities and challenges. The Company’s management strongly believes that the Company has gone through the most difficult phrase and it is in a way to continuous healthy development. With the continuous concern and support of its shareholders as in the past and the concerted efforts of all its staff, the Company will fulfill its operational goals and build a solid foundation for its future development and strive towards becoming the “No.1 Home Appliances Brandname in the PRC”.